Supreme Court, U.S.
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No. 01-1209

In the Supreme Court of the United States

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

REPLY BRIEF FOR THE PETITIONERS

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REPLY BRIEF FOR THE PETITIONERS

At the heart of this case is a circuit split involving a significant and continuing issue affecting the application of federal export incentive statutes aimed at leveling the playing field for U.S. exporters vis-à-vis their foreign competitors. This federal tax legislation, enacted in three successive iterations, has been in effect for 30 years, and affects significant numbers of this country's largest corporations and leading exporters.[1]

The Eighth and Ninth Circuits have issued conflicting decisions regarding which of two contradictory expense allocation provisions of the Treasury Regulations applies in the context of the export incentive provisions. The government concedes that this circuit conflict exists. However, the government attempts to diminish the importance of the circuit split by erroneously asserting that the conflict disappeared with the enactment of the FSC provisions. In fact, an analysis of the regulations shows that, as the government stipulated and the Ninth Circuit recognized below, the relevant DISC and FSC provisions are substantively the same. Thus, the conflict continues into the FSC years. Furthermore, because ETI, the third iteration of the export provisions, contains essentially the same provisions, the issue remains important into the future.

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[1] As explained in more detail in the petition, the original provisions adopted in 1971 provided export incentives through the use of Domestic International Sales Corporations (DISCs). I.R.C. §§ 991-997. In 1984, the DISC regime was replaced with the Foreign Sales Corporation (FSC) provisions of sections 921-927. In 2000, the FSC regime was replaced with the Extraterritorial Income Exclusion (ETI) regime. I.R.C. §§ 114, 941-943. Unless otherwise noted herein, all Code and section references are to the Internal Revenue Code of 1954 or 1986, as amended and in effect during the relevant time periods, and the Treasury regulations thereunder.

The export incentive provisions involved in this case provide that, in making the relevant income calculations, taxpayers must deduct R&D expenses that are directly related to a given product category *only* from income generated by that product category. For this purpose, taxpayers are allowed to choose to group their products by product line either according to recognized industry or trade usage or by SIC code, and the taxpayer's choice of such product line grouping "will be accepted" by the Internal Revenue Service (IRS).

The decision below effectively supplants these rules by *requiring* taxpayers to allocate R&D expenses by grouping products only by SIC code, thereby forcing them to allocate R&D directly related to certain product lines to other product lines to which they are not related. Significantly, the government makes virtually no attempt to defend the Ninth Circuit's erroneous reasoning that leads to this perverse result.

The Ninth Circuit's decision undermines the national export incentives embodied in the DISC provisions. It also subverts the uniform application of the federal income tax laws, creating a situation in which taxpayers in two circuits would be taxed differently based solely on the locations of their headquarters. In addition, as the *amici curiae* explain, taxpayers in other circuits now face uncertainty as to which of the two conflicting expense allocation regulations takes precedence in applying the federal export incentive provisions. Billions of dollars over many years – past, present and future – potentially are at stake in this case. Review by this Court is therefore imperative.

A. There is a Direct Circuit Split of Ongoing Importance.

1. The government concedes that a circuit conflict exists with respect to the DISC provisions affecting the majority of Boeing's taxable years at issue in this case. Br. in Opp. 18. The Eighth Circuit in *St. Jude Medical, Inc.* v. *Commissioner*, 34 F.3d 1394 (1994), concluded that Treas. Reg. § 1.861-8(e)(3) was invalid as applied to the calculation of combined

taxable income (CTI) under the DISC provisions. The Ninth Circuit specifically "decline[d] to follow the reasoning of *St. Jude Medical*" (Pet. App. 10a), and upheld the application of Treas. Reg. § 1.861-8(e)(3) to the computation of CTI for purposes of the DISC and FSC provisions.

In a startling turnabout, however, the government denies that a conflict exists with respect to the FSC provisions, claiming that the FSC provisions are "materially different" from the DISC provisions. Br. in Opp. 18. This transparent attempt to diminish the importance of the circuit split is contrary to the government's previous stipulation, positions in its briefs, and published statements. The parties long ago correctly agreed that "[a]lthough there are some differences between the DISC and FSC rules, *none of them relate to th[e] issue in this case*." Stip. ¶ 28 (emphasis added). Moreover, the government has acknowledged that "[a]lthough there are * * * differences between the DISC and the FSC rules, none of them relates to the issue in this appeal, which is common both to DISCs and FSCs. * * * *[W]hat we say about a DISC will be analogously true of a FSC.*" U.S. 9th Cir. Br. 22 (emphasis added).[2] And in its published Action on Decision stating that it would not acquiesce in *St. Jude Medical*, the government announced that "this issue should continue to be litigated and/or defended since it also arises in the context of Foreign Sales Corporations." AOD 1999-005 (Aug. 30, 1999). Concurring in the government's longstanding position that the issue is identical under both DISC and FSC, the Ninth Circuit concluded that "the differences between these statutory schemes are not relevant to this appeal." Pet. App. 6a n.3. The Ninth Circuit did not, of course, make any attempt to distinguish *St Jude Medical* on this basis.

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[2] The district court confirmed that "[a]lthough there are some differences between the DISC and FSC provisions, the parties agree that the calculation of the CTI on export sales is essentially the same for both." Pet. App. 20a n.2.

The government attempts to justify its reversal of position by pointing to the absence from the FSC regulations of redundant language from the DISC regulations that provided that the taxpayer's choice of grouping is "controlling" and that costs shall "be allocated and apportioned to the items or classes of gross income * * * resulting from such grouping." Br. in Opp. 21. This argument is frivolous. An analysis of the export incentive regulations confirms that the relevant provisions have remained substantively unchanged for nearly 30 years. These provisions consistently establish (a) that expenses directly related to a product group may be allocated only to that group, and (b) that taxpayers may choose to allocate expenses on the basis of product lines grouped either by recognized industry or trade usage or by SIC code, and a taxpayer's choice binds the IRS.

The DISC and FSC regulations *both* provide that, for purposes of calculating CTI, "expenses * * * definitely related" to export property and "a ratable part of any other expenses * * * which are not definitely related" thereto must be allocated to income from such property. Treas. Reg. § 1.994-1(c)(6)(iii); Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(D). *Both* regulations allow taxpayers to make these computations "on a transaction-by-transaction basis" or "on the basis of groups consisting of products or product lines." Treas. Reg. § 1.994-1(c)(7)(i); Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(i).[3] Under

[3] The government notably omits this important provision of the FSC regulations from its appendix, thereby leaving the impression that this key provision of the FSC regulations vanished by 1989. That is not so. The "1989" version of the FSC regulation (Temp. Treas. Reg. § 1.925(a)-1T(c)(8)) reproduced in the government's appendix (Br. in Opp. App. 3a, 6a) is actually that regulation after an amendment in *2001*. See Grouping Rules for Foreign Sales Corporation Transfer Pricing, 66 Fed. Reg. 13,427 (Mar. 6, 2001). The 2001 amendment simply moved the product grouping language quoted in the above text from the *temporary* FSC regulations to the *final* FSC regulations (Treas. Reg. §1.925(a)-1(c)(8)(i)). Thus, that language remains fully operative today. In fact, it has been part of the export incentive regulations continuously from their inception.

both regimes, this taxpayer election "will be accepted" by the IRS if the determination is based on either "recognized industry or trade usage" *or* two-digit SIC code. Treas. Reg. § 1.994-1(c)(7)(ii)(a); Temp Treas. Reg. § 1.925(a)-1T(c)(8)(ii).

The language of *both* the DISC and the FSC regulations therefore squarely conflicts with Treas. Reg. § 1.861-8(e)(3), which requires taxpayers to group their transactions *solely* by SIC codes. Accordingly, because the courts of appeals are in conflict with regard to the DISC issue (as the government concedes), a conflict necessarily exists with regard to the FSC issue. Review by this Court is therefore required to resolve a clear and irreconcilable dispute between the courts of appeals on this significant issue of federal law.

2. The government argues that this case has no prospective importance because the future application of DISC and FSC has been restricted, and no regulations exist under the current iteration of the export incentive regime, ETI. Here, too, the government is plainly wrong. Indeed, ETI so closely parallels FSC (and therefore DISC) that Congress has specified that all relevant FSC regulations continue to apply for ETI purposes; indeed, Congress's directive refers *specifically* to the FSC grouping regulations.[4] Thus, under ETI, as under DISC and FSC, the taxpayer's choice of grouping "will be accepted." Temp. Treas. Reg. § 1.925(a)-1T(c)(8)(ii). As was clearly stated in the ETI Conference Report, "[u]nder the grouping method, the conferees intend that *taxpayers be given reasonable flexibility to identify product lines or groups* on the basis of *recognized industry or trade usage*." H.R. CONF. REP. NO. 1004, 106th Cong., 2d Sess. 195 (2000) (emphasis added). Accordingly, the issue in this case remains as important as ever.

[4] H.R. CONF. REP. NO. 1004, 106th Cong., 2d Sess. 207 (2000).

The government asserts that "[r]ules promulgated under the ETI could * * * reasonably address, and remove, the asserted 'conflict' in the regulations that was the premise for the decision of the court of appeals in the *St. Jude* case." Br. in Opp. 17 n.10. It is *always* possible that a regulation could change in the future. But that mere possibility is no reason to deny certiorari. The government does not represent that any such change has been made or even proposed.

3. The conflict between the Eighth and Ninth Circuits leaves the tax law in turmoil. Without resolution of this conflict, taxpayers in the Ninth Circuit will be forced to apply a far more costly expense allocation regulation than taxpayers in the Eighth Circuit, including, in some cases, their competitors.[5] Taxpayers outside these two circuits will be left without clear judicial guidance on how to apply the export incentive provisions.

The government attempts to dismiss the issues in this case as "extremely narrow, technical questions" of little relevance. Br. in Opp. 22. This self-serving assertion ignores the widespread use and importance of the export provisions. As is evidenced by the filing of the *amici curiae* briefs in this case, the issue is of enormous significance to many taxpayers.[6] The IRS is still auditing many companies for tax years to which the

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[5] The significance of this potential competitive disadvantage can be seen by the dollar amount at issue in this case for just one taxpayer over a nine-year period (over $400 million).

[6] As noted in the *amici* briefs submitted in support of the petition, other taxpayers affected by the DISC and FSC regulations include such large corporations as General Electric, Intel, Microsoft, Brunswick, Hewlett-Packard, Reebok, Union Carbide, General Dynamics, Oracle, Caterpillar Tractor, KLA-Tencor, Dresser Industries, and St. Jude Medical. TEI Am. Br. 9-10; Brunswick, et al. Am. Br. 1-5. It has been estimated that aggregate annual tax benefits from the FSC regime for the year 2000 alone will be $4 billion. Pet. 24.

DISC and/or FSC provisions apply.[7] In addition, many corporations with open statutes of limitations are eligible to file claims for refunds of income taxes paid during DISC and/or FSC years. Perhaps most significant of all, the existing uncertainty undermines ETI's purpose of stimulating American exports into the future.

B. Review by this Court is Needed Because the Holding of the Ninth Circuit is Wrong.

The government makes virtually no attempt to defend or rely on the reasoning of the court of appeals whose judgment it seeks to sustain. Little could betray the weakness of the Ninth Circuit's opinion more tellingly.

The Ninth Circuit's mandatory application of the § 1.861-8(e)(3) allocation rule would force taxpayers to allocate R&D strictly by two- or three-digit SIC code product groups, thereby causing R&D expenses completely unrelated to export income nevertheless to be allocated to that income. That result simply writes out of the export regime's regulations the provision authorizing all expense allocations to be made by recognized industry or trade usage product groupings.[8] By the same token, the opinion also effectively writes out of the export regulations the mandate that expenses "directly related" to export property be allocated *only* to that export property. Treas. Reg. § 1.994-1(c)(6)(iii); Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(D).

The government claims that Boeing's method of allocation "violat[es] the requirement that 'the *total costs* of the DISC and related supplier which relate to such gross receipts' be deducted

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[7] See TEI Am. Br. 9.

[8] It is undisputed that Boeing's product line groups were in accordance with recognized industry or trade usage. Pet. App. 2a, 16a. Moreover, Boeing adopted its accounting methods for internal management reporting purposes well before any of the export incentives were enacted.

in computing CTI." Br. in Opp. 23 (emphasis in original). But the regulations clearly state that only the total costs that *relate to* gross receipts must be deducted. This general mandate is carried out by the specific requirement that those costs "definitely related" to a product group can be attributed only to that product group. Treas. Reg. § 1.994-1(c)(6)(iii); Temp. Treas. Reg. § 1.925(a)-1T(c)(6)(iii)(D). The regulations leave no room for taking a portion of the expenses that *are* in fact related to a particular class of export property and apportioning them to other, *unrelated* property. Yet that is exactly what the Ninth Circuit's rule would require.

A strict mandate to allocate expenses solely by SIC code would force taxpayers to allocate expenses to products to which those expenses bear absolutely no relation and would lead to absurd results. For example, bicycles and motor scooters are in the same 2-digit SIC code as Boeing's aircraft (SIC code 37 "Transportation Equipment"). The Ninth Circuit's holding would thus require a taxpayer to allocate R&D expenses relating to a nascent or failed airplane development program to income from the sales of bicycles.

The government argues that the likelihood of such an irrational allocation will be "more remote" because a 1995 amendment changed the SIC code reference in Treas. Reg. § 1.861-8(e)(3) from 2-digit SIC codes to 3-digit SIC codes (Br. in Opp. 22). In fact, precisely the same problem arises with reference to 3-digit SIC codes. Hang gliders, balloons, and blimps are in the same 3-digit SIC code as Boeing's aircraft (SIC code 372, "Aircraft and Parts"). It simply makes no sense to allocate the R&D expenses incurred to develop a jet fighter to the income from hang gliders, any more than it makes sense to allocate expenses incurred in the development of a mainframe computer to the income from pencil sharpeners or staple removers (all within the same 3-digit SIC code 357, "Computer and office equipment").

Notably, the issue that arose in *St. Jude Medical* would not be any different had the case been decided after the post-1995 section 861 regulations were in place. That case involved three medical products (insulin pumps, pacemakers, and prosthetic heart valves) within the same 2-digit SIC code. The same 3-digit SIC code (SIC code 384, "Surgical, Medical, and Dental Instruments") still encompasses all three products. It also includes such disparate items as corneal microscopes, heart-lung machines, ultrasound equipment, cotton balls, artificial limbs, crutches, whirlpool baths, wheelchairs, operating tables, and space suits.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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